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SURETY BONDS AND SURETIES IN THE CONSTRUCTION INDUSTRY

BY

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A REPORT PRESENTED TO THE GRADUATE COMMITTEE
OF THE DEPARTMENT OF CIVIL ENGINEERING IN
PARTIAL FULFILLMENT OF THE REQUIREMENTS
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CHAPTER 1
SURETY AND CONSTRUCTION

1.1 Introduction

The concept of suretyship is an old one. The Bible, the Code of Hammurabi, and the Magna Carta contain many pertinent references to suretyship. Solomon warns in the Book of Proverbs, "he that is surety for a stranger shall smart for it." The leading issue in Shakespeare's Merchant of Venice was the contract of suretyship entered into by Antonio and Shylock. Shylock was to take a pound of Antonio's flesh if Antonio's friend, Bassanio, was unable to pay his obligation to Shylock.

Suretyship has far reaching applications in business and commerce today, particularly in the construction industry. Surety bonds play a major role in allocating particular risks within the tangled web of parties to a construction project. Sureties guarantee the construction contractor will meet its contract obligations, but a construction project owner may find getting the surety to act on its guarantee is not often an easy chore. Technical defenses which rely on an overlap of commercial and surety law make are often used successfully by sureties to minimize their losses.

1.2 Surety Bonds: What are They?

Simply stated, a surety bond is a guarantee against failure to perform. Construction project owners often require their prime contractors to purchase surety bonds as a means of providing themselves protection against contractor failure. Sureties agree to indemnify the bond "obligee" (project owner) from losses it may sustain as a result of the bond "principal's" (contractor's or "obligor's") failure to perform its obligation. Suretyship; therefore, like insurance, transfers risk to a professional risk-bearer. However, suretyship should not be confused as insurance. Surety bonds are closer in likeness to a form of credit than an insurance policy. A basic premise of suretyship, as in any case involving the extension of credit, presumes there will be no loss. When a banker extends a line of credit, he fully expects loans to be repaid. Therefore, surety bond premiums are essentially "service fees" based on the cost of underwriting the bonds, rather than actuarial principles.

Unlike the insurance industry, sureties are entitled to be exonerated, indemnified, and held harmless from loss by their customers (contractors). When there are losses, sureties may assume the rights of the parties they protect against their customer. These rights are enforced through the principle of subrogation.

There are three types of bonds commonly required on construction projects:

(1) Labor and Material Payment Bonds,
(2) Performance Bonds, and
(3) Bid Bonds.

Bid bonds are submitted to the project owner at the time of bid submission. Payment bonds and performance bonds are usually submitted by the winning contractor prior to the start of work. They are generally referred to collectively as "contract bonds."

1.2.1 Labor and Material Payment Bonds

Should the contractor default in his payment obligations, a payment bond guarantees the surety will pay subcontractors, laborers, and material suppliers those amounts due to them under the terms of their contractual agreements with the contractor. The payment bond ensures the private owner will be able to take possession of a lien-free project at project completion. Depending upon the bond or the statutory provisions governing it, payment bonds typically apply to subcontractors and suppliers to the principal (prime contractor). However, question often arises regarding the second-tier subcontractors, the suppliers and materialmen of the subcontractor, and the suppliers of the suppliers. Case law relies on the wording of the particular bond (1:232).

The meaning of the word "labor" as used in the payment bond is not restricted to physical labor. It is given a broad meaning to accomplish the intent of the bond. Technical and professional services used in inspection and testing are covered under the bond; services performed in connection with the transportation, loading, and unloading of materials; and project supervision have been held to be labor within the meaning for payment bonds.

The payment bond references the construction contract and establishes a cumulative limitation, or penal amount, which caps the surety's total liability exposure on the bond. A common limitation is fifty percent of the contract price, even though it may not be sufficient to pay all subcontractors and suppliers if all were to sue.

1.2.2 Performance Bonds

Performance bonds are written for the owner's protection. If the construction contractor fails to complete the project in accordance with its contract, a performance bond guarantees the surety will either (1) complete the contract themselves, (2) arrange for another firm to complete the contract, or (3) pay for the cost of completion. However, the surety will not be responsible to pay more than the penal sum or limit of liability stated in the bond. The penal sum is usually equal to one hundred

percent of the contract amount. Project owners usually feel there are too many risks to consider less.

The owner's right to call on the surety to complete is filled with technicalities. Most bonds require the contractor to first be held in default. There are usually substantial battles between the contractor and owner over the propriety of the termination, and most sureties will back the contractor in these fights. Also, many bonds require that the project owner must give the surety the option to complete the work before the owner can decide to complete the work itself. The project owner has a duty to minimize the damages to the surety as much as possible when a contractor defaults. Thus, if the surety declines to complete the contract after the contractor defaults, the owner has a duty to obtain the lowest possible price when awarding a contract to complete the project (2:31).

The performance bond incorporates the terms of the construction contract by reference, including all warranty periods required by the construction contract. In fact, depending on the contract terms, the protection provided by the performance bond occasionally overlaps that of the payment bond. Although a performance bond does not guarantee the principal's creditors will be paid, a recent court decision (Case 1-1) ruled that, depending on the express terms of the contract, the surety on the performance bond may be made to pay a subcontractor's claims.

Case 1-1 Performance bond may permit subcontractor recovery (from 1:234)

The Superior Court of New Jersey, Appellate Division, has ruled that a performance bond issued to a general contractor for the protection of the owner may be used to pay a subcontractor [*Amelco Window Corp. v. Federal Insurance Co.*, 317 A.2d 398 (1974)].

A prime contract for a university project provided that the owner could require the general contractor "to furnish bonds covering the faithful performance of the Contract and the payment of obligations. . . ." Although the contract further stated that the contractor would pay for all labor, materials and tools, the owner only required the posting of a performance bond.

The bond, obtained from a surety company, was issued "in accordance with the terms and conditions of said prime contract," which were incorporated in the agreement.

After entering into several contracts, the general contractor went bankrupt.

The question before the court was whether the subcontractor could sue the surety company for payment of its unpaid claims even though the bond contained no provisions for payment of any subcontractor claims.

Noting that this was a case of first impression, the court said that the rights of the subcontractor were dependent upon the contractual relationship that existed in the surety agreement. If the bond promised "either in express words or by reasonable implication" to pay the subcontractor, it would be a beneficiary to the surety agreement.

Stressing that the wording of the bond did not expressly exclude subcontractors from its coverage, the court stated "the surety bond incorporates the prime construction contract by reference, the two being integrated must be considered together."

The court concluded that the bond was conditioned on the full performance of the contract and so the subcontractor was permitted to sue the surety company for its claims.

Many owners require their contractors provide performance bonds due to the severe consequences of a contractor's failure to perform. Also, many lending

institutions require the contractor furnish a performance bond as a precondition to financing (3:142).

1.2.3 Bid Bonds

A bid bond is a form of bid security. It accompanies a bid and guarantees the bidder will either enter a contract with the project owner within a specified period of time, furnishing whatever bonds may be required by the contract, or pay for any additional costs the owner may incur in contracting with the next lowest qualified bidder. The bond's stated limit is referred to as the penal sum, and is the limit of the surety's liability under the bond. The principal is afforded the same limitation. The amount of the penal sum is usually based on the probable range of bid prices, typically between five and fifteen percent of the amount of the contractor's bid or proposal. The bond form includes the determined percentage rather than a converted dollar figure. This allows some flexibility, as contractors will invariably wish to change their bid figures at the last moment before submission. Oftentimes there may be several contractors bidding on the same project with bid bonds from the same surety. Even with the most respectable bonding source, a contractor would be foolish to provide their exact bid price on a bond before the bids are opened.

Should a contractor begin contract work before submission of the required performance and payment bonds,

the bid bond has been declared in some cases to have essentially the same meaning. There have been at least two reported federal cases in which payment bonds were never posted, yet unpaid labor and material claimants were afforded recourse from the surety issuing the bid bond (4:466).

The use of bid bonds often raises the question of whether they constitute a performance commitment. When asked this question, sureties reply that issuance of a bid bond is essentially a commitment to post a performance bond should the principal's bid be accepted. However, they qualify this based on the "fundamental status of the account [having] not changed between approval of the bid bond and the principal's receipt of an award" (4:468). Among the various changes which may occur, by far the most frequent source of concern is the size of the principal's bid in comparison with the other bidders. Sureties pay very close attention to the bid spread. Variations of ten percent or more are almost certain to evoke serious reevaluation. Sureties will often employ outside consultants to review the contractor's likelihood of success (4:468). At the very least, the principal will have much explaining to do, and he may find himself shopping for another surety. Serious bidding errors will usually encourage the principal and surety equally to drop out through the best available means.

This may involve agreement or renegotiation with the owner, forfeiture of the bond, or litigation on the bid bond.

All sureties review the final bid results as soon as available. Most sureties keep a continuous record of the principal's bidding history, and a careful tracking of its standing in the reported results (4:467).

1.3 Who Requires Surety Bonds? Public vs. Private Works

The U.S. Congress passed the Heard Act in 1893 requiring contractors to obtain surety bonds on federal construction projects. This was superseded by the Miller Act (40 U.S.C. 270a-270d) in 1935. Virtually every state followed with enactment of "Little Miller Acts." All federal and most state, county, and city governments, require performance and payment bonds on projects greater than $25,000 (5:192).

Recognizing that federal projects are not subject to mechanic's liens, the Miller Act provides the only legal recourse for an unpaid subcontractor or supplier to pursue payment. When a contractor on a federal project fails to pay his bills, the suppliers and subcontractors have the right to sue the contractor in the name of the United States. The suit must be filed in the U.S. District Court that has jurisdiction over the area in which the contract was performed. Because of this important public policy, the scope of coverage stipulated in the Miller Act is mandatory.

A bond may provide broader coverage than required by statute, but it may not provide less. In a sense, the statute supersedes the terms of the bond itself. Missing provisions will be read into the bond and restrictive provisions which conflict with the statute will be ignored (6:1).

Private projects use common law bonds whose coverage and functions stand entirely on the provisions contained in the bond itself. In contrast with Miller Act payment bonds, bonds on private projects are not intended to primarily protect subcontractors and suppliers. These bonds, usually required by the terms of the construction loan agreement, are designed to protect the owner and lender by keeping the project free of mechanic's liens. The bonds are usually written and enforced in a manner which provides a payment guarantee only to laborers, subcontractors, and suppliers that have perfected their rights under the applicable state mechanic's lien statute. A party without lien rights on a private project becomes a party without payment bond protection. Since the bond serves to protect the private owner, the owner may waive an existing bond requirement without notice to the subcontractors and suppliers on the project (6:7). It is common practice to use standard common law payment bond forms approved by professional groups such as the American Institute of Architects.

Under a Miller Act payment bond, first-tier subcontractors and material suppliers, and second-tier subcontractors and suppliers that deal with first-tier subcontractors are protected. The payment protection of this federal statute extends no further (7:2). As noted previously, bonds on private projects usually apply to unpaid parties that possess valid lien rights.

1.3.1 What Interest Should Architects, Engineers, and Owners Have in Bonds?

Surety bonds are a vital part of the competitive bidding system on public contracts. Surety bonds go a long way towards making it conscionable to award a contract to the lowest responsible bidder. The bonds guarantee the contractor will perform the construction project according to the terms of the contract, on time, at the agreed upon price, and free of liens.

In addition to protection for the owner, subcontractors, and suppliers, those who design and award construction contracts benefit from the requirement for surety bonds. According to the surety industry, subcontractors and suppliers quote their lowest prices for bonded projects because they know the credit risk has largely been removed (8:8).

Private project owners generally do not require surety bonds. This difference between public and private projects

is a direct result of the laws and rules governing public procurement by contract. Private industry traditionally invites a few highly qualified bidders, whereas the federal government opens the bid to all interested contractors. The protection offered by surety bonds reduces the risk to the government when it awards contracts to the lowest responsible bidder. Bonding requirements noticeably transfer the duty of investigating and qualifying a contractor to an impartial party. The surety's investigation can be reasonably expected to be thorough and reliable. A 1976 General Accounting Office study affirmed the wisdom of the requirement for bonds, and stated that the federal government was not equipped to prequalify contractors itself (9:2).

There is an increasing trend among private owners to require surety bond protection. It is worthy to note that there are a few state statutes that require payment bonds on privately financed work (5:186). Subcontractors and material suppliers are often asked to provide bonds which hold their primary contractor as the obligee. Prime contractors that require their subcontractors to retain their own bonds are often granted a greater capacity for bonding by their surety companies.

1.4 Sureties

The concept of suretyship is as old as commerce itself and can be traced back to early civilization. Prior to the Industrial Revolution the only available sureties were wealthy individuals. This method of protection often proved to be unsatisfactory as the project owner was forced to qualify the surety. Individual sureties were later replaced by corporations whose financial worth was easily determined. In the United States and Canada these corporations are often divisions or subsidiaries of insurance companies. The U.S. Federal Register publishes each July a list of such companies. Individual sureties still exist today, but they make up only a small percentage of the bonding market (8:9).

1.4.1 Corporate Sureties

Typically all contractors use the services of national corporate surety companies whose specialties are the writing of bid bonds and contract bonds for contractors. The firms are subject to public regulation in the same manner as insurance companies. They operate under charters and file their schedules of premium rates with designated public authorities. Since the true worth of a surety bond is no greater than the surety's ability to pay, project owners retain the right to approve the surety company and the form of bond. The federal government requires that all corporate sureties proposed for use on federal projects be approved by

the U.S. Treasury Department. The resultant list of surety companies approved for federal projects can be a valuable reference for private owners also.

It is possible on contracts for private work to require that the contract bonds be obtained from a particular surety. However, this is opposed by most professional organizations in favor of leaving the contractor free to obtain bonds from a surety of its choice. There are a few states with statutes that prevent an owner from requiring a contractor to obtain contract bonds from a designated surety (5:197).

On very large contracts single sureties may seek their own protection by inviting other sureties to underwrite a portion of the contract. Treaties are written between the sureties much like reinsurance. The original surety remains completely responsible for the penal amount of the bond as far as the beneficiaries are concerned. Oftentimes the original surety will take full responsibility for an initial percentage of a bond as it is invoked, but share liability for the remaining balance amongst a "pool" of sureties. The financial resources which make up the pool are at far less risk than the original surety's resources which back up the initial percentage. The surety companies determine the percentage based on the complexity of the particular project and the parties involved (10:1). The pool should be at a relatively low risk compared to the original surety.

Sometimes the owner requires the contract bonds be provided by cosureties, where two or more sureties split the total obligation among them. This serves to spread the risk over the participating sureties and thereby reduces the amount of risk to which each is exposed. This also gives the owner a measurable degree of protection against possible financial default by a single surety. Cosureties are occasionally necessary on large federal projects because of limits established by the U.S. Treasury Department on the maximum amounts of single contract bonds which a given surety is permitted to execute (5:198).

1.4.2 Surety Agents

Most surety companies will only accept business through independent agents and brokers. These agents are known as surety bond producing agents. This is the person with whom the contractor must deal directly when obtaining bid and contract bonds. Their middle position benefits the contractors and the sureties. The contractor has an opportunity to dress rehearse every proposal, and has someone available for consultation who is not only thinking in terms of accepting or declining the bond application. Mutual confidence can be created between contractor and agent. This can be turned into candid and practical suggestions and advice which can then be converted into positive approaches to the surety. The agent is a trained

observer of the construction industry who has a detached point of view and whose advice is therefore particularly valuable to the contractor (9:19).

Understandably a contractor may get the impression that the producing agent is unduly meddling in its affairs or is overly limiting its volume of work. However, the contractor should feel fortunate that the surety is interested in helping avoid the many pitfalls associated with the management of a construction firm. Like contractors, some agents are more conservative than others. It is up to the contractor to select a responsible and competent agent who is responsive to its needs.

In keeping with Section IV of the English Statute of Frauds, a surety bond must always be in writing (11:91). The bid bonds and contract bonds that are provided to the contractor seldom, if ever, originate directly from the home office of the corporate surety. The documents are prepared and signed by the producing agent. In order to verify the authenticity of the producer as an agent of the surety, it is required that each construction surety bond include an appropriate power-of-attorney form attached to the bond. This will be either without limitation, or subject to a dollar limitation within which the agent is empowered to execute the bonds. Other restrictions may be imposed on the agent by the surety, but these are kept strictly between them. Some agents are given no discretion, while others may

be given a wide authority, often for only one or more accounts (4:468). Either the bond document or power-of-attorney should be impressed with the corporate seal of the surety (8:9).

Despite the producing agent's prominent role in the bonding process, they have absolutely no role in the claims process under the bonds. The sureties' claims departments deal directly with the involved parties.

1.4.3 The SAA and the NASBP

The Surety Association of America (SAA) is the trade association and licensed rating/advisory organization for the surety business. The Association currently represents 538 American surety companies. It engages in educational activities, assists in developing potential markets and lobbies for the interests of suretyship in the U.S. and abroad (12:10).

The National Association of Surety Bond Producers (NASBP) is the international organization of professional contract surety agents and brokers. It works toward increasing the effectiveness of the surety industry (12:10).

1.4.4 Individual Sureties

The Federal Acquisition Regulations allow contractors to pledge certain assets, such as real property, to support a bond. Two separate individuals are normally required to

pledge, each with sufficient financial holdings to cover the penal amount of the bonds. However, this unregulated alternative has led to some unscrupulous activities, especially during periods when contractors with less than gold plated credentials cannot get bonds. There were flagrant abuses during the 1980's on both small and large contracts. Most problems arose because the pledged assets, if they existed, were pledged many times over. Case 1-2 from an account by Engineering News Record is a brief illustration of what often happened. Although no direct count of individual surety fraud cases was ever made, there was enough lobbying from the various professional construction organizations and the federal agencies being bitten, that the subject was brought before the Senate Subcommittee on Federal Spending, Budget, and Accounting in 1987, chaired by the Honorable Lawton Chiles (13:1).

Case 1-2 Individual surety fails to complete Navy project (from 14:29)

Several small Baltimore-area construction firms are facing financial hardship because of what they claim was the U.S. Navy's negligence in not sufficiently investigating a minority-owned contractor's payment and performance bonds from an individual surety.

The Navy awarded a $4 million contract through the Small Business Administration in 1988 to renovate a 50,000 square foot Naval reserve training building at Fort McHenry in Baltimore. The job was awarded initially to Sheppard's Interior Construction Inc., a locally based minority-owned firm. It provided the Navy with surety bonds from Jack Berman of Bay Harbor Island, Florida, and the Navy accepted the bonds.

Sheppard's filed for bankruptcy in March 1991 after completing only a portion of the project and the Navy turned the job over to Berman for completion. He contracted with Dave Gemmel Inc. (DGI), a small Maryland contractor.

Berman initially made payments to DGI for its work, but those payments soon stopped, leaving the firm unable to pay its subcontractors. DGI notified the Navy, but the Navy continued making payments to Berman until it finally terminated the contract with Berman. The affidavit that Berman gave the Navy lists more than $14 million of assets, but DGI claims their private investigator found Berman "doesn't own anything."

Berman owes $412,000 to DGI, and about $300,000 more to several other firms which worked on the project.

A rule took effect in 1990 which limits the types of assets that may be pledged and requires that they be worth at least the penal amount of the bonds. The rule notes specific assets which are unacceptable, including: accounts receivable, foreign securities, foreign real estate, a surety's main residence, jewelry, corporate assets, and speculative assets such as mineral rights. In addition, the surety must provide "objective evidence" of ownership of the assets (15:18). Individual sureties must also provide the

federal government with a security interest in the pledged assets through a lien on real estate or an escrow account with a federally insured financial institution on other than real property. Before accepting the bonds, federal contracting officers are required to get a legal opinion on "the adequacy of documents pledging assets" (16:16).

However, legislative and administrative moves under consideration may lead to the establishment of a federally sanctioned association of individual sureties, at least on a test basis. A bill introduced by Congresswoman Cardiss Collins (D-Ill.) would set up such an association. She said the 1990 rule change "all but eliminated individual sureties as a source of bonding for minority construction contractors" (m19:21). Under her bill the association would be required to maintain a certain loss reserve and have limits on outstanding work in process. In addition, a contracting officer who denies a contract award to a firm with an individual surety would have to publish the reasons in the U.S. Federal Register (17:22).

The Association of General Contractors and American Subcontractors Association were satisfied with the 1990 rule change, and are now concerned with "the opportunity this bill offers to undermine the reasonable standards governing individual surety" (17:22). The National Association of Minority Contractors says the bill provides hope to hundreds

of minority firms "who are just barely hanging on" and hoping for some relief from the rule change (17:22).

1.4.5 Letters of Credit

Contractors who do not qualify for corporate surety bonds or cannot enlist the support of an individual surety on public projects, often want to substitute letters of credit for bonds. However, the Miller Act does not permit the substitution of letters of credit. The type of letter of credit which would be used to guarantee a contractor's performance is a "standby" letter of credit. It is normally issued by banks and runs to the owner of the construction project. The letter is executed by the owner upon demand. The bank simply pays the amount of the letter of credit to the owner (18:1).

This contrasts sharply with the surety bond. The performance bond is directly tied to an underlying contract and responds if the contractor defaults in performing the contract. The surety has duties to both the contractor and the project owner.

1.5 Obtaining Bonds

Today's competitive environment makes the ability to obtain bonding a high priority of construction firms. Firms that do not have a bonding program in place cannot bid on

most public and many private projects. Surety bonding is often considered to be a Contractor's "lifeblood" (19:38).

To obtain bonding, generally a contractor must start out in business performing work on which bonds are not required, building a track record of several successfully completed jobs, creating a record of owner satisfaction, and establishing a record of prompt payment to subcontractors and suppliers. Next the contractor must be able to convince the surety that he is "qualified" to successfully undertake the construction contract he is seeking. When weighing a contractor's qualifications, sureties traditionally consider a contractor's "three Cs": character, capacity, and capital.

However, a contractor is not qualified simply by having money in the bank, or owning construction equipment, or having previously constructed a building, or having a crew of skilled workers, or having a good record of payment to subcontractors and suppliers. These are all very important, but the surety's evaluation probes much deeper (20:8-5). The surety underwriter thoroughly investigates the principal to determine his likelihood of satisfactorily performing the project to be bonded.

Surety companies will be more receptive to granting bonding requests from contractors if they can show consistent financial performance; good control over their billing and collection procedures; a consistent ability to estimate gross profit; and a willingness to disclose

information about related transactions. The following list from the SAA and NASBP brochure, Your First Bond, identifies what a contractor will probably need to present to a surety in preparation for its first bond:

> An organization chart that shows the key employees and their responsibilities;
>
> Detailed resumes of the firm's owner and key personnel;
>
> A business plan outlining the type of work the firm does, how it obtains contracts, the geographic area in which it operates, and its growth and profit objectives;
>
> A description of some of its largest completed jobs, including the name and address of the owner, the contract price, the date completed, and the gross profit earned;
>
> A plan outlining how the business will continue in the event of death of the firm's owner, or that of another key employee;
>
> Subcontractor and supplier references including names, addresses, and telephone numbers of persons to contact;
>
> Evidence of a line of credit at the firm's bank (sureties look for an unsecured line of credit that can be used to meet short-term cash requirements when needed); and
>
> Letters of recommendation from owners, architects, and engineers.
>
> Sureties want to see fiscal year-end statements for the firm's past three to five years. Financial statements should include:
>
> > Accountant's Opinion Page
> > Balance Sheet
> > Income Statement
> > Statement of Cash Flow
> > Schedules of Contracts in Progress and Contracts Completed
> > Schedule of General and Administrative Expenses (21:5-8).

Financial statements can be prepared by accountants on three levels, known as audit, review, and compilation. Sureties prefer audited fiscal year-end statements. An audit report with an unqualified opinion is the highest level of assurance a CPA can give financial statements. Auditing is a sophisticated process which involves gathering and evaluating evidence to test the conformity of the financial statements with generally accepted accounting principles. A review statement consists principally of inquiries of the firm's people and application of certain analytical procedures to the financial data. Although far narrower in scope than a full audit, the review does provide some limited assurance about the financial statements. A compilation provides very little assurance of the credibility of the figures because the accountant is not required to follow normal audit procedures or acceptable accounting principles.

Sureties look for strong and complete financial statements. They should be prepared using the percentage of completion method of accounting to measure contract revenue. Appendix A includes a list of suggestions to improve financial statements in the eyes of a surety. The list is from a manual entitled Boosting Your Bonding prepared by a surety bond producing agent in Rockville, Maryland.

To establish and maintain a relationship with a surety company, a contractor should develop an internal program to

ensure constant communication. Successful financial and operational management will present a strong, unified case to the surety (22:4). Once a contractor has firmly established relations with a surety company, the contractor's bonding capacity becomes reasonably well established. Future investigations by the surety are concerned with keeping the contractor's records current and investigating the individual bond requests as they are submitted.

When the firm's maximum bonding capacity is approached, or when an unusually large or completely new type of construction project is proposed, approval of the bond application may require a relatively long period of time or it may be denied (5:199). Sureties are very interested in the aspects of any new project which may somehow vary from the contractor's previous accomplishments. The most important items of concern are listed here.

1. The essential characteristics of the project under consideration, including its size, type, and nature. Included here would be the identity of the owner and its ability to pay for the construction as it proceeds.

2. The total amount of uncompleted work the contractor presently has on hand, of both the bonded and unbonded variety.

3. The adequacy of working capital and the availability of credit. The contractor can assist its own cause by keeping the surety fully informed as to its activities and supplied with current financial reports.

4. The amount of money the contractor "left on the table," that is the spread between the low bid and the next highest.

5. The largest contract amount for similar work the contractor has successfully completed in the past. Inexperience in a new field of construction has caused many contractor failures. The surety would like the contractor to stay with the kind of work in which it is most experienced. If the contractor is not properly equipped for the new work, it must be demonstrated to the surety how the equipment problems will be solved.

6. The details of how payment will be made to the contractor, retainage, time for completion, liquidated damages, construction warranties, and other contract terms.

7. The amount of work subcontracted and the qualifications of the subcontractors. Suretys are concerned about the experience and organization of the prospective subcontractors. (5:199-200)

1.5.1 Indemnity

Since surety bonds guarantee a firm's performance and payment of bills, the surety fully expects the contractor will live up to those obligations. Therefore, the principal is asked to sign an indemnity agreement. This indemnity is required of both the contracting firm, and the firm's owners and their spouses. The indemnity agreement obligates the named indemnitor to protect the surety from any loss or expense, presumably assuring that they will stand fast in the face of problems, and use their experience and financial resources to resolve any difficulties which may arise in the performance of the bonded work.

By obtaining the personal guarantee or indemnity of a third party financial backer, an otherwise qualified contractor can help increase its bonding outlook. The third

party contributes credit to the contractor in return for a share of the profits (5:198).

1.5.2 Bonding Capacity

The construction industry loosely uses the term bonding capacity to describe the maximum value of uncompleted work the contractor can maintain before the surety will cease to provide bonds on any new concurrent projects. Bonding capacity is often determined as a multiple of a contractor's net quick worth. Net quick worth is obtained as quick assets minus current liabilities. Quick assets are those that can be immediately converted to cash. The multiple can vary substantially according to the individual contractor and the field of construction involved. Typically the surety uses a multiple between eight and ten (12:6). When a surety grants a line of surety credit to a contractor, it may restrict the maximum contract value which a contractor may enter to a percentage of the bonding capacity (5:201).

The surety considers both bonded and unbonded projects when calculating total uncompleted projects to determine a contractor's position with respect to its bonding capacity. The contractor can often increase its capacity by requiring its subcontractors to be bonded.

Contractors may increase their bonding capacity by investing cash on hand into the company. An investment can

usually increase capacity by ten times the amount of the investment.

If a surety becomes concerned about a contractor's finances, the surety will often reduce the contractor's bonding capacity. This is why succession planning is critical. If a key stockholder was to die without a succession plan, such as a buy-sell agreement funded by life insurance, the surety is very likely to drastically cut back the firm's bonding capacity. A firm often finds itself crippled severely because of this (23:14).

1.5.3 Bond Premiums

Most surety companies charge nothing at all for issuing bid bonds, but sureties have little interest in issuing bid bonds for any project which does not require a performance bond. Such cases occur when private owners want to save on the cost of bonding, but desire the added assurance of dealing with a qualified contractor. Instead of a bid bond, this owner might ask for a "bid letter," the surety's commitment that it will post a performance bond should one be asked for if its principal wins the job. Sureties will reluctantly issue these with language as general and open as possible (4:467). The entire underwriting process is clearly geared toward the writing of performance bonds.

The premium for performance and payment bonds is not a premium in the sense that one pays a premium when purchasing

an insurance policy. The cost of contract bonds is a fee to the surety for prequalifying the contractor to which the contract is awarded, and for lending its credit, in effect, to that contractor (20:8-3). The premium is a percentage of the amount of the contract to be bonded. Bond premiums generally cost from less than one percent to two percent of the contract price.

Construction is classified into four types by the surety companies when considering bond premiums: A1, A, B, and Miscellaneous. A limited listing of the construction types within these categories is given in Figure 1-1. Premium rates for contract bonds vary between surety companies, and are adjusted up or down depending on a contractor's loss experience. The rates also vary on an incremented scale according to the value of the contract. An example is shown in Figure 1-2. Rates apply to a standard one year warranty period. If additional warranties apply, additional charges are made (5:194). All separate subcontracts are assigned the same classification as the general contract such that only one classification will be assigned to a single project. If more than one classification applies, the classification with the higher bond rate will be used (5:194).

Figure 1-1 Classifications for contract bond premium rates. (from 5:195)

Classification			
A1	A	B	Misc.
Ash conveyors	Airport grading	Air conditioning	Bridges
Boilers	Arpt runways	Airport bldgs	Prefab bldgs
Conveyors	Alum. siding	Aqueducts	Culverts
Doors	Ball flds	Breakwater	Demolition
Fire alarms	Beacons	Buildings	Dredging
Fire escapes	Cielings	Canals	Hauling
flag poles	Coal storage	Dams	Highways
Floors, wood	Curb& Gutter	Docks	Maint
Gas tanks	Curtain wall	Elec work	Overpass
Generators	Ducts, u/g	Excavation	Roads
Guard rails	Elevtors	Foundation	Shoring
Ironwork	Floodlights	Gas piping	Paving
Kitchen equip	Glazing	Grain elev	Struct stl
Lock gates	Greenhouse	Heating	Test borings
Metal windows	Machinery	Furnace	
Meters	Millwork	Jetties	
Pipelines	Murals	Masonry	
Police alarms	Parking lot	Piers	
Radio towers	Parks	Pilings	
Refrig plants	HP Piping	Powerplant	
Scaffolding	River Bank	Sew. sys.	
Sidewalks	Roofing	Plastering	

Figure 1-2 Premium rates for contract bonds. (from 5:196)

Contract Price	Premium Rate per $1000 of Contract Price for First 24 Months* (Subject to change without notice)			
	Class A1	Class A	Class B	Misc.
First $500,000	$6.00	$9.00	$12.00	$12.00
Next 2,000,000	5.00	5.60	7.25	10.00
Next 2,500,000	4.10	4.40	5.75	8.20
Next 2,500,000	3.70	4.10	5.25	7.40
Over 7,500,000	3.30	3.70	4.80	6.50

* For construction time over 24 months, increase basic premium by 1 percent per whole month.

1.6 Bonds and Contract Types

The bonding industry is structured to respond to traditional methods of project delivery, but adaptations are made for some of today's innovative techniques.

1.6.1 Design/Build

Design/build participants may experience difficulty obtaining adequate coverage since the design professional and the contractor may be legally responsible for aspects of a project traditionally out of their control. They may be involved in activities for which the surety companies typically do not provide protection (3:133).

Project design is a professional function, and as such, it cannot be bonded. However, design professionals who are responsible for the construction of a design/build project may need to be bonded. Criteria the typical surety company uses to evaluate a potential principal's bonding capacity may make it difficult for the design professional to obtain bonding. A design professional in this situation could depend on the bonding capacity of the contractor, but may forfeit a degree of project control by doing so (3:145).

Also, the surety may have difficulty evaluating the bonding capacity of a party engaged in design/build since the cost and scope of the work, as well as the allocation of responsibility, are often unclear.

1.6.2 Cost Plus Fee Contract

The face value of the contract bonds is determined from an initial target price established for the work to be done by 2the contractor. The bond premium is finalized when the final contract price of the project has been determined (5:203).

1.6.3 Joint Venture

Each venturer bonds its proportionate share of the contract price. The contractors' usual sureties jointly u2nderwrite the project and sign bonds as cosureties (5:203).

1.6.4 Construction Management

The functions of the construction manager (CM) are considered professional services, and are not bonded. Bonds are provided to the owner by each of the prime or trade contractors. Protection for the owner from CM negligence is provided by the CM's professional liability insurance (5:204).

CHAPTER 2
BONDS AND SURETIES AT WORK

2.1 Obligations of the Surety

Every year many construction firms, large and small, old and new, fail for a variety of reasons and cause their sureties to pay out many millions of dollars in losses. "For every successful new contractor, there are ten or more failures" (20:8-9). The primary cause of failures, which result in surety losses, stems from underbidding of contracts and poor management. This includes:

a. Over-extension - The contractor undertakes operations on a scale greater than it is capable of completing. When contractors seek jobs outside their specialty or geographic area, cost overruns and/or labor and subcontractor problems often result.

b. Inadequate supervision - This may include limited experience, poor training, or lack of ability.

c. Inefficient operations - This may be due to hesitancy to undertake new methods of performance or to properly upgrade equipment.

d. Lack of proper job cost and accounting records and procedures - The contractor must be aware at all times of its financial condition and have access to past and current job data.

e. Failure to arrange for proper financing - This includes money for operating capital and for equipment expenditures.

f. Unwisely entering into hazardous ventures - Unless adequately financed and equipped, what commences as a profitable undertaking can end in economic loss.

g. Lack of business acumen - Reducing costs and overhead in a down economy is necessary. Many contractors state they need a certain volume to pay their overhead. When the volume is not profitable, changes must be made.

h. Mistakes in estimating functions, both mechanical and judgement errors. This includes not allowing for contingencies which should be expected. (8:17)

Generally the surety does not get directly involved in a construction contract unless and until the contractor is terminated for default. Whatever the degree of default, it is in each parties' interest that the contractor advise the surety, the sooner the better.

The surety is obligated to protect the owner. The surety must consider the rights and privileges of the contractor under the terms of the contract with the owner. If these rights have been prejudiced, the surety will choose its course of action accordingly. Sureties are very careful not to usurp their principal's position by entering into a contract dispute too hastily.

Payment and performance bonds routinely require that timely notice be given to the surety when the surety's principal defaults or when a claim on the bond will otherwise be made. Sureties traditionally argue that such notice provisions must be complied with, otherwise they claim their obligation under the bond is discharged. This argument has rarely been accepted with regard to performance bonds; however, reasonable notice provisions on payment bonds are usually strictly construed (24:7).

2.1.1 Cancellation of Contract Bonds

Contract bonds cannot be canceled by the principal or the surety once they have been executed. This is true even in cases of fraud or nonpayment of the premium to the surety company. The bond is a three party contract with the contractor and the surety joining in a guarantee to protect a third party, the owner. The law is clear that regardless of the relationship between the contractor and surety, no penalty or damage can be permitted against the innocent third party, who is the beneficiary of the bond (20:8-8).

2.2 Claims by Subcontractors and Suppliers

The right of a laborer, supplier, subcontractor or anyone else who furnishes labor and materials to a prime construction contractor, to be paid for their services has been recognized for centuries. In order to protect such rights, the various states enacted lien laws to secure a certain priority of payment and thereby assist in the collection of payments due for services performed on construction projects. However, since all federal property is owned by the people, the courts have held it is not proper for liens to attach to any federal projects. As discussed previously, Congress passed the Miller Act in lieu of granting lien rights on federal projects. The Act prohibits the government from waiving the requirements for a payment bond, but even in certain cases where the government

has waived it, the United States was still not held liable to unpaid subcontractors (9:7). The courts confirm it is the responsibility of subcontractors and suppliers to monitor the prime contractor's compliance with the payment bond requirements (6:7). The limitation of parties protected by a Miller Act payment bond is strictly enforced, and commonly copied in Little Miller Acts as can be seen in Case 2-1.

Case 2-1 Holding a contract with a first-tier supplier given no recourse under the contract payment bond (6:7)

A prime contractor on a Maryland state project issued a purchase order to a quarry for riprap. The quarry hired a trucking firm to transport the riprap. It was held that because the quarry was working under a purchase order rather than a construction contract and performed no work at the site, the quarry was a supplier, not a subcontractor. The trucking company was therefore denied protection under Maryland's Little Miller Act [*Atlantic Sea-Con Ltd. v. Robert Dann Co.*, 582 A.2d 981(Md. 1990)].

The courts, including the Supreme Court, have ruled that the Miller Act is to be liberally construed in favor of those making claim on the bond, but within the limits of the Act (9:7).

Suppliers have a burden of proof that the materials it sold were actually incorporated into the project. Some payment bonds for private projects expressly impose this burden on suppliers. However, suppliers are held to a more

lenient standard on public projects (6:7). Since the realities of daily business make it difficult to prove whether individual supplies are actually incorporated into the project, the courts rarely require proof of anything more than delivery of the materials to the site of the bonded project. Under the Miller Act and some Little Miller Acts, a supplier does not even need to prove delivery to the job site. All that is required is the sale of materials with the good faith belief the materials were intended for use in the bonded project. However, if a supplier sells on an open account with no knowledge of the materials destination, it cannot satisfy the good faith belief that particular materials were going to be used on a bonded project. The use of the good faith defense by suppliers to first-tier subcontractors can put the prime contractor and its surety in an unfortunate position. Case 2-2 describes a current case in Maryland.

Case 2-2 Contractor responsible for materials that cannot be located (10:1)

A prime contractor on a project for the Maryland DOT subcontracted with a local firm for the installation of guard rail. The subcontractor began having financial problems and defaulted on its subcontract before ever installing any guard rail. The prime contractor entered into a follow-on subcontract with a different firm which then performed the guard rail work.

A supplier to the defaulted subcontractor is now suing the prime contractor and surety under the payment bond claiming it supplied guard rail to the defaulted subcontractor on the project site. There is no record of the guard rail on the site, but the supplier has an invoice recording so. The defaulted subcontractor is insolvent and unable to confirm the whereabouts of the guard rail.

The case does not look good for the surety and the prime contractor because the supplier had a good faith belief that the materials were to be incorporated into this bonded project.

2.2.1 Elements of Recovery

The payment bond guarantees the contractor's payment obligations to laborers, subcontractors, and suppliers. The bond covers the agreed contract prices which are established in the subcontracts and purchase agreements, which include components of overhead and profit.

Basic rules need to be applied when computing the contract balance owed a claimant under a payment bond. Firstly, all progress payments must be credited to the account of the bonded project. Subcontractors may not apply the funds to satisfy a pre-existing debt of the prime

contractor. Also, any credit which accrues must be applied to that project.

Most cases to date have refused to apply the bond to delay claims, "but under the recent trend of enlarging liability, surety companies are being held liable for increased costs of materials, extended loss of efficiency costs, and other direct out-of-pocket costs which are part of delay claims" (1:233). Case 2-3 is given as an example.

Contributions to employee welfare funds are covered under a Miller Act payment bond; although, worker's compensation premiums are not covered, unless required by an agreement between the contractor and the labor union to be made to an employee's trust fund. The furnishing of medical and hospital care to the employees of a contractor are not recoverable under the Miller Act payment bond.

The U.S. Supreme Court declared in 1974 that attorney's fees under a Miller Act bond would not be recoverable unless a state statute or contract provided for their recovery, or it was found that the losing party acted in bad faith (9:12).

Case 2-3 Miller Act bond covers delay claim costs (from 1:236)

A. U.S. District Court in Washington, D.C., has allowed a subcontractor to recover on a prime contractor's Miller Act bond for additional labor and material costs the subcontractor claimed were caused by extensive delays [*United States of America v. rel. Leonardo Mariana v. Piracci Constr. Co., Inc.*, 405 F. Supp. 904 (D.C. 1975)].

A dispute between the General Services Administration and its general contractor delayed construction of a museum for nineteen months. When work resumed, the subcontractor found that its labor, material, and administrative costs had increased substantially. To recover these extra costs, the subcontractor sued the general contractor's surety company, claiming that these costs should be paid under the Miller Act bond.

The Miller Act requires contractors on Federal projects to put up a surety bond to guarantee payment to all persons supplying labor and material to the contractor. Congress passed this law to protect subcontractors and suppliers because lien rights do not exist on federal projects.

In court, the surety argued that it was not liable for these additional costs because its bond stated: "If the...[general contractor]...shall promptly make payment to all persons supplying labor and material in the prosecution of the work provided for in said contract, and may any and all duly authorized modifications of said contract that may hereafter be made...then the above obligation...shall be void and of no effect."

Because the contractor had already been paid its full subcontract price, it could not recover on the bond, the surety claimed.

The court said the real issue in the case was whether the delayed costs were expenses for labor and material under the Miller Act.

Finding that the additional costs were actually out-of-pocket expenses, the court said that "the Miller Act surety is liable to a subcontractor for increased costs actually incurred due to delay for labor and material, to the extent that such delay is not attributable to the subcontractor." To rule otherwise, the court said, would place the contractor in the position that Congress was trying to avoid when it passed the Miller Act.

2.2.2 Notice Under the Payment Bond

Most payment bonds contain provisions requiring that notice be provided and claims initiated within certain periods. A common claim limitation is one year from the date labor or materials were last furnished to the project. Under the Miller Act, suit may be filed by first-tier claimants no sooner than ninety days and no later than one year after last furnishing labor or materials. No other form of notice is required. The ninety day period is designed to give the parties an opportunity to work out their payment problems without resorting to the bond.

However, according to the Act, second-tier claimants must provide written notice to the prime contractor within the initial ninety day period after last supplying labor or material "for which such claim is made." The courts have ruled that the ninety day notice period begins to run when the second-tier subcontractor leaves the job site, even if it expects to return and finish the work (9:14). One court has allowed a second-tier subcontractor to base the ninety day notice on a third-tier subcontractor's last day of performance (9:15). The ninety day notice period cannot be extended by providing start-up assistance with equipment. The one year claim limitation period cannot be extended by the performance of remedial punch list work (25:7).

Regarding the reasons for strictly construing the notice provisions in payment bond cases, the Florida Supreme Court explained in a 1982 case:

> . . . [T]he construction industry is well aware of the necessity of giving timely notice, and the notice provision here appears to be fairly standard throughout the industry. . . . National Gypsum is, at best, merely a donee third-party beneficiary of the instant bond. We see no reason to allow National Gypsum to enjoy the benefits of the bond without bearing its burden as well. . . . While it is true that sureties are in the business of writing bonds for profit, it is equally true that they may contract for notice as a condition precedent to trigger their responsibility on the bond. Notice provisions help sureties determine the amount of reserves they must keep on hand for potential claims. The amount of reserves required are one of the factors which determine the premium rates on the bond. If proper notice is given, as contracted for, the surety may have an opportunity to intervene on the project and attempt to utilize its business or legal remedies and thereby minimize potential losses and ultimately keep premium rates down. (24:18)

Other courts have upheld the reasonableness of the notice provisions on the basis that "sophisticated parties have a right to have their contracts enforced without being rewritten by the courts" (24:18).

2.2.3 "Pay When Paid" Clauses

Construction subcontracts are customarily structured such that payment to the subcontractor is conditioned upon prior receipt of payment by the prime contractor from the owner. The payments "trickle down" after the approval of the architect, the project owner, and the prime contractor. Normally the agreement will be structured in such a way that

payment is due within a certain period of time after the prime contractor receives payment from the owner, and so forth down the tiers of contractors. Problems frequently develop on private projects when the owner does not make its payments to the prime contractor because of owner insolvency, bankruptcy, or a contractual dispute. Through no fault of the lower tier subcontractors, the time period provisions for payment cannot be fulfilled.

The courts have been called upon to interpret the so-called pay when paid clauses to determine whether the clauses provide an absolute condition to payment of the lower tier contractors, or whether it only provides a manner and time of payment. The overwhelming majority of jurisdictions interpreting the pay when paid clauses have held that the contractor, and its surety, are liable to a subcontractor, even if the owner is unable or unwilling to pay the prime contractor (26:27). However, there are no cases which have refused to enforce pay when paid clauses which very clearly state that payment is conditional upon payment to the prime contractor, merely many cases where the language of the clause is ambiguous (26:27). However, one would think a prudent subcontractor would not enter such an agreement.

2.2.4 Diversion of Materials from Bonded to Unbonded Jobs

Case 2-2 begins a look at how easily a contractor and its surety can be put in a bad position. The case has yet to go to trial, but it points to a common problem. The materials were not incorporated into that project, perhaps they were stolen, or perhaps the defaulted subcontractor took delivery of the materials but used them on an unbonded project. If the subcontractor was having financial problems, its suppliers might have been tightening up. They may have limited their sales to the subcontractor to bonded jobs only, which would ensure they were protected under a payment bond. Similar cases have occurred where subcontractors and prime contractors diverted materials in this manner. Orders for materials on a simple bonded high school have been sufficient to build the World Trade Center in New York. Problems arise if the supplier is not paid. In this case the contractor and its surety are in need of a defense. Factors which will determine their success include the actual scope of bond coverage and the involvement of the claimant himself in the diversion. The claimant's records should be thoroughly reviewed (27:456).

2.2.5 Joint Check Arrangements

A joint check arrangement is typically an agreement between the prime contractor and a subcontractor to issue

the subcontractor's progress payments in the form of a check made payable jointly to the subcontractor and one of his suppliers or sub-subcontractors. This theoretically gives each party leverage to control the disposition of the payment, giving each payee the bargaining power necessary to ensure that it will receive its proper portion of the proceeds.

The arrangement is usually meant to reduce the chance of a subcontractor running off with the progress payment, leaving the supplier empty-handed. The use of joint check arrangements can establish a case whereby the surety and the prime contractor would be relieved of their obligations under the bond. Should the supplier be allowed protection under the bond if it unwisely releases its leverage over the payment by accepting an unsatisfactory deal with the subcontractor? This question has received a mixed reaction from the federal courts, but others generally agree that joint check arrangements may discharge the surety's obligation under the payment bond (28:8).

2.3 Providing Financial Support to the Contractor

When a contractor encounters financial difficulty which jeopardizes its ability to perform its obligations, the contractor may consider seeking financing from its surety. If the contracting firm is basically sound, a surety may help keep a job moving by guaranteeing a line of bank credit

for the contractor. If claims have tied up the contractor's capital, the surety may furnish bonds to discharge these claims. Such arrangements occur privately and more often than one might realize. As a result of such financing the Surety Association of America reports that "hundreds of millions of dollars are paid out annually to progress bonded jobs, without the assistance of courts, without any formal default process and often without any direct notice to the owner or bond obligee" (29:9).

Of concern to the financing surety is the potential that the principal's creditors will attempt to treat the surety as the alter ego of the principal, making the surety liable for anything that the principal is liable for. Recent cases favor the surety. In *John G. Lambros Co. v. Aetna Casualty & Surety Co.* [468 F. Supp. 624 (S.D.N.Y. 1979)], the court stated:

> It is not unusual for either a surety or a secured creditor advancing large sums of new capital to become "intimately involved in [the debtor's] financial affairs." Such involvement does not merge the identities of the creditor and debtor as plaintiff would have it, nor does it expose the creditor to contract liability on obligations of its debtor other than those it has agreed to assume. . . . In sum, plaintiff's claim is without merit and constitutes a thinly veiled attempt to gain a preference over other creditors by suing the defendant rather than pursuing its remedies as a creditor against [the contractor]. (30:1194)

If the principal believes the surety's financing and "assistance" actually damaged the construction firm, it may claim that the surety "dominated" its affairs, and thereby

seek recovery from the surety. There has been little reported litigation on this subject, but it remains a real concern to the surety (30:1196).

The extent of financing by the surety depends upon the project and the contractor. Three situations are commonly encountered: virtually all of the contractor's work is bonded, and one surety writes all the bonds; virtually all the work is bonded, but several sureties are involved; or the contractor has substantial unbonded work, and the remaining bonded work is with one surety, or split among several. Each situation has its own advantages and disadvantages. In particular, no surety wants to pay for the contractor's overhead, but the contractor cannot operate without it. Unbonded work, "coupled with some creative accounting, will often allow the contractor to generate the revenue necessary to pay overhead and costs not directly allocable to bonded projects, while each surety finances its own projects" (30:1203).

Financing is obviously risky for the surety. Gilbert Schroeder, a surety lawyer from Illinois, says it invites disaster.

> The reasons are endless for a "good contractor" running into financial problems which are "not really his fault," causing a "temporary cash flow problem." Not only are they endless, they are false. Other contractors made it, and he did not. No amount of sugar-coating will change this. (30:1205)

A brief synopsis of the arguments for or against financing which are considered by the surety are listed below.

Arguments in favor:
a. Job momentum and continuity
b. Contractor's image
c. Additional bonds
d. Salvage made easier
e. Avoiding increased price of completion by another contractor
f. Status of work: substantial completion

Arguments against:
a. No offsetting reduction in bond penalty
b. Payment of overhead obligations
c. Uncertainty as to amount of loss
d. Status of work: just beginning
e. Commitment of surety personnel to field construction
f. Extensive unbonded work (31:1174-1177)

2.4 Default by the Principal

2.4.1 Notice under the Performance Bond

One of the fundamentals of suretyship is that an obligee is under no duty to give notice of a principal's default to the surety unless he has contracted to do so, and even then the obligee's failure to notify the surety is considered a minor technical breach. The American Institute of Architects General Conditions of the Contract for Construction, AIA Document A201 paragraph 14.2, requires that an owner notify the prime contractor and its surety of a default within seven days of the default action. Although sureties argue that such provisions are a condition precedent to liability under bonds, courts have not accepted

it. Courts require a showing of prejudice to the surety before performance under the bond will be excused or limited (24:8). With regard to notice provisions, courts also consider the surety's inevitable knowledge of the problem despite the lack of written notification from the owner.

2.4.2 Completion Options

Should the contractor default, the surety is required to perform in accordance with the terms of the bond. Options to the surety may include:

a. Use the principal to complete,
b. Complete with another contractor,
c. Offer the owner another completing contractor,or
d. Decline to Complete.

When the contractor defaults and the surety undertakes to complete the work, the surety becomes entitled to all of the remedies the owner has against the contractor under the contract. In addition, the surety is entitled to receive from the owner the balance of the contract price, which is normally defined similar to that of the AIA Document A311, "as the total amount payable by Owner to Contractor under the contract and any amendments thereto, less the amount properly paid by Owner to Contractor" (5:202). Provisions of the Miller Act or other governing statute apply as well. The surety will also pursue any claims against the owner which the defaulted contractor may have had.

Use the Principal to Complete: The surety may "use" the principal in several ways, all of which depend on the extent to which the surety is willing to fund the contractor and keep the contractor's personnel on the particular project. The surety may use little more than the principal's name and one knowledgeable employee, and subcontract the rest. On the other extreme, the surety may keep the contractor's forces intact and simply supervise progress and exercise control over the job funds (32:1216). The principal at this point is likely to have little negotiating power with the surety, but; nevertheless, the principal's management should be looking out for their firm. The extent of the surety's and their inevitable consultant's involvement must be clearly understood.

Complete with Another Contractor: More often, the surety will takeover the principal's contract and award a separate completion contract to another contractor. This is usually the only method allowed on federal projects with Miller Act bonds (31:1178). The federal agency may require approval authority over the selection of the new contractor. An attempt will be made by the surety to induce the principal into approving the new contract price. Any new contract should specifically indicate the extent to which the new contractor will be responsible for the original contractor's work. The less the responsibility, the lower the price is likely to be (32:1120).

The surety should receive an irrevocable assignment of the contract balances at its first meeting with the owner. Arrangements should be formulated in writing, usually in two separate documents. A Takeover Agreement outlining the surety's intentions is entered into with the owner. A completion contract is entered with the new contractor.

The surety will probably find it necessary to negotiate with some of the major subcontractors on the project. Their continued presence is likely to help hold down the costs to complete.

Offer the Owner Another Completing Contractor: The surety may suggest that the owner award a completion contract to another contractor. In such an arrangement, the surety will be able to remain detached from the completion of the project. The surety may choose this course of action when the cost to complete is very high, perhaps exceeding the bond penalty. This may be desirable to the surety if it cannot obtain the consent and cooperation of the defaulted contractor in choosing a contractor with whom the surety itself might complete the contract. A public owner may insist on this course of action if the surety's financing and capabilities are suspect.

The funding of an owner's completion contract may take one of several forms. The surety may write a check to the owner for the difference between the original contract balance and separately bonded completion contractor's price

to complete, and the owner in turn gives the surety a release. In this case the surety would be discharged from any further obligation, leaving it to pursue indemnification from the defaulted principal.

If the owner will not agree to release the surety up front, the surety may agree to reimburse the owner for the increased cost of completing the project at the end of the project.

A third method is for the surety to supplement each progress payment to the new contractor in appropriate ratio with the owner.

Lastly, the surety may withhold payment of the differential until contract disputes are resolved with the owner, through litigation or otherwise.

Decline to Complete: A surety may decide to do nothing about its obligations, at least from outward appearances. In every case, the surety and its consultants will conduct an investigation and document its file. If the surety feels the principal has been defaulted by the owner in error, any involvement in completing the job by the surety could end up being at its own expense. If the default is valid; however, the longer the surety waits, the greater impact delays will have on the cost to complete.

The indemnitors to the surety may give the surety another alternative to paying for the completion of the job. Demand is made upon the indemnitors to arrange for and fund

the completion of the project. If the indemnitors do in fact have the means to finance the completion of the project, but refuse to do so, the surety may consider filing an "exoneration" action against them (32:1223). Usually this is a slow process, but should result in minimizing the surety's final outlay on the project. By acting quickly, the surety will minimize the time the indemnitors have to dissipate their assets.

There are many variations of options available for completion after a default by the principal. The best option for a particular project and default situation cannot be answered in advance. The impact of such variables as the integrity and motivation of the responsible parties will play a major role.

2.5 The Contest for Retainage

Suppliers and subcontractors to construction work often find themselves faced with an insolvent contractor who has failed to pay debts owed them, and they are unable to collect their claims under the payment bond. This may happen because they failed to notify or sue within the time period set forth in the bond or statute, perhaps the penal sum of the bond was exhausted, or the supplier or subcontractor's claims are not covered by the payment bond. Under such circumstances, suppliers and subcontractors have sought recovery under the performance bond or from retained payments.

A large number of recovery actions through the performance bond have succeeded, but many have failed also. Success has often occurred for those particular cases where the contract language expressed or implied a promise or an obligation by the contractor to pay laborers and materialmen, as if this was an integral part of the required performance (33:1073). Case 1-1 was a prime example. If recovery cannot be accomplished through the performance bond, then the supplier or subcontractor often looks to the contract retainage which is commonly held back from progress payments by the owner until final completion of the project.

Public and private construction contracts condition the owner's release of the retainage to the prime contractor on there being no unpaid bills for labor and materials. If such debts exist, the owner may pay them directly from the retainage (33:1074).

These contractual provisions are important to both private and public owners. If a private owner has made full payment to a contractor and a supplier or subcontractor is not paid, the owner may have to pay the supplier to remove a lien on his property. Although public construction is sheltered from lien actions, governments are interested in the provisions because they provide a means of protecting laborers and materialmen other than through the required bonds, and thus act as encouragement to undertake more public projects (33:1074).

Believing these contractual provisions reveal an intent to protect and secure payment to suppliers, courts have allowed suppliers priority in recovery from retainage by the owner. This is principally based on the theory that the suppliers acquired an "equitable lien" on the retainage (33:1074). This idea was initiated in the case of *Henningsen v. United States Fidelity & Guar. Co.*, [208 U.S. 404, 410 (1988)] where the surety was allowed priority over the contractor's bank assignee in recovery from the retainage, since the surety had "released the government from all equitable obligations to see that the laborers and supplymen were paid" (33:1075). Some courts have held that suppliers are third-party beneficiaries of the retainage under those contract provisions, and are thereby entitled to preference over the contractor's assignee or trustee in bankruptcy (33:1075). Also, many states have statutes which provide for the filing of liens on any fund retained by a government agency on a public construction contract.

On completed projects when an unbonded supplier or subcontractor is wrestling for the retainage and the surety asserts a claim based on an assignment from the contractor, the supplier has been granted priority. On completed projects where the surety is contending for the retainage as a subrogee or assignee of the suppliers covered under the bond, some courts have denied the surety a right to share in the retainage, whereas others have allowed the surety, as

subrogee of the suppliers, to share the retainage proportionally with the unbonded suppliers (33:1076).

However, priority to the retainage changes when the contractor is terminated for default and the work has not been completed. In the event the surety elects not to take over the completion of the work, the owner needs the funds to complete the work. The owner can only recover from the surety the excess cost beyond the original contract price.

In those cases where the surety completes the work, suppliers and subcontractors lacking coverage under the bond and other creditors are normally denied priority to the retainage when competing with the surety. In cases involving public projects, a completing surety has been denied priority over suppliers and subcontractors not covered under the bond only on rare occasions. A 1984 case in Florida, *Transamerica Insurance Co. v. Barnett Bank of Marion County, N.A.*, ruled the bank was entitled to the retainage because it made the appropriate filings under the state's Uniform Commercial Code (34:16). The state's Fifth Circuit Court of Appeals said state law applied. The ruling was reversed, however, in the state Supreme Court. The judges said, "The interests of all concerned parties . . . are best served by prompt performance by the surety" (35:16). Giving priority to the bank effectively removed the surety's motivation to perform the completion itself. Therefore, the case was overturned.

Private construction adds a different problem. The defaulted contractor often leaves unpaid suppliers with liens on the improvement. The contractor's failure to remove these liens has been considered covered by the performance bond "since the owner, although not personally liable to these suppliers, is forced to pay them in order to clear his property from their liens" (33:1079). It follows that in a contest for the retainage between a completing surety and suppliers or subcontractors with liens on the private improvement, but without recourse under the bond, the suppliers and subcontractors will prevail, since the owner is entitled to have those liens paid out of the retainage before the completing surety can use it to recover the cost of finishing the work (33:1079). When the completing surety is paid the retainage, the surety is assumed to hold the obligation to pay any lienholder, bonded or not (33:1079).

The superior right of the completing surety to the retainage stands on firmly established principles of subrogation law. In both the public and private interest, it provides incentive to the surety to assume completion of the work after the contractor defaults. The retainage on a defaulted contract should not be made subject to the claims of suppliers until it has accomplished its primary purpose of defraying the cost of completion to the owner or the surety.

2.6 The Contest for Construction Materials

There are many potential claimants to construction materials on the job site that have not been installed as of the principal's default termination. They include the suppliers and their various creditors, subcontractors and their various creditors, the prime contractor and its secured creditor, the owner and its creditors, and the surety. Generally the superior claims are the surety's and the prime contractor's secured lender's.

The indemnity agreements with the principal usually give the surety a contractual security interest in the principal's materials. However, if a secured lender has been given the materials as collateral after the issuance of the bonds, but before the default, the secured lender should prevail according to the Uniform Commercial Code (36:6).

The surety may also claim its subrogation rights in its favor. Since subrogation rights "arise out of the surety's eventual right to be in the shoes of the owner/obligee," and the owner has a superior right under the Uniform Commercial Code, this angle has been successful for some sureties (36:7).

Of course, the surety also has a subrogation right to the rights of the suppliers and subcontractors which it pays. The Uniform Commercial Code does provide certain limited rights to those suppliers who are alert enough to use them. The Code provides that a seller of goods who

learns that his buyer is insolvent may, within ten days of the delivery of the goods to the insolvent buyer, demand reclamation (36:10). If the surety recognizes that a supplier has exercised this right, it could establish the surety's superior subrogation right.

The issues regarding rights to the construction materials are varied. There is a complicated overlap between commercial law and surety law. Combined with the large number of potential claimants, its a haven for lawyers.

2.7 Arbitration

Many construction contracts today require arbitration in the event of a dispute between the parties. Sureties often take the position that the obligee on the bond cannot directly arbitrate with the surety unless the surety consents to having its matter solved in arbitration. This can create a problem when the owner obtains an arbitration award against the contractor, and the surety attacks the award and seeks to have the matter heard anew in litigation (37:38).

A recent decision in the District Court of Maine has revealed some insight on the question. The court felt any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, and recommended that if a surety intends not to be bound by arbitration, a specific

caveat should be placed into the bond which requires the parties to litigate their disputes (37:40).

2.8 Statutes of Limitation

The majority of states have passed statutes creating a specific limitation period for legal actions regarding bodily injury, or damages to real or personal property, against the architects, designers, engineers, and construction contractors involved in a construction project. During the past twelve years, some of the statutes have been amended to specifically provide for inclusion of sureties. Without specific language regarding sureties, courts will likely refuse to include them within the protection of the statute (38:3). However, if they are included within the statutes protection, the statute might be deemed a statutory minimum that cannot be contractually shortened by the surety. The limitations are generally shorter than the time for bringing suit for breach of contract. A model statute developed by the AIA and the National Society of Professional Engineers recommended a limitation period of four years (39:1059). In the absence of such a statute of limitation, the general rule is that an action brought against a surety is governed by the statutes of limitation for contracts (39:1060).

CHAPTER 3
BARRIERS TO SURETIES

3.1 Bonding Problems for Small Contractors

The number of sureties writing payment and performance bonds for small contractors has climbed 34 percent since 1988, which was the surety industry's first profitable year since 1979 (40:10). About 140 surety companies are now doing business with contractors with annual revenues of $2.5 million or less (41:11). This list includes the fifteen largest sureties in the country, as well as thirty companies which do not appear on the U.S. Treasury Department's list of approved sureties. Nevertheless, the surety industry is harshly criticized by small contractors who feel they are unfairly denied access to bonds. The surety industry claims small contractors now have more opportunity than ever before, but more bonding sources does not necessarily mean access is any easier according to the American Subcontractor's Association (ASA).

Small contractors complain that they are denied bonds by surety bond producing agents who frequently are unqualified to make informed decisions or fail to explain why bonds are denied. One in four subcontractors, out of a poll of 135 in 1988, reported that their agents conditioned

the writing of surety bonds on the writing of that company's insurance policies. Such tie-ins are considered an illegal restraint of trade according to the ASA (42:11).

Subcontractors are disconcerted because there is a definite trend toward more subcontractor bonding. They ask, "how are we supposed to cope?" About 20 percent of the subcontractors say they have used alternatives to corporate surety bonding. These include individual sureties, letters of credit, certificates of deposit, and cash (42:11). Minority contractors claim they have been hurt by the federal government's decision to stiffen the requirements for individual sureties (43:50).

One promising program that may ease the problem is the Small Business Administration's "Plan B." The program allows the SBA to guarantee the bonds of small contractors that cannot obtain bonds in the commercial market. Surety agents set the contractor up with a surety which will provide the bonds. If there is a claim on the bond, the SBA will cover 80 percent of the loss. SBA will guarantee bonds only for firms with average annual revenues of $3.5 million working on projects worth less than $1.25 million (19:39).

In addition, a relatively new ASA program offers members a limited bonding capability. Members can request any number of bonds up to $500,000 each or a total of $1.5 million (44:15). The program is designed to supplement

corporate surety bonding. Applicants must meet the same criteria used by other sureties, but this program is happy to consider the firms which only need one or two bonds per year. The ASA has been working to expand this program to all the states. They expect fifteen percent of their members to use the program (44:16).

3.2 Environmental Problems

There are no reported cases of any hazardous waste liability claims against a surety on a contract performance bond, but sureties are deeply troubled by the thought of it. The surety's obligations under the performance bond will probably be determined to include the obligation to clean up the site with all the accompanying environmental liabilities since the surety's exposure is coincident with that of the principal. The environmental regulations set forth in the 1980's have had far reaching affects on liability which are reflected in exorbitant prices for environmental remediations. Therefore, contractors which pursue environmental clean-up and abatement work are usually not welcomed with open arms by the surety industry. Nevertheless, contractors are required by federal and state regulations to either acquire surety bonding or set aside an amount equal to the contract amount as security. The surety industry's reluctance to provide bonding is cutting

competition on "Superfund" jobs thereby raising the cost of the clean-ups (45:8).

Obtaining bonds for asbestos abatement contractors is a serious problem also. Sureties have been fearful of the flood of contractors into the abatement business and the many associated failures. There is an improving trend as insurance coverage improves and as surety underwriters gain knowledge of the business.

3.3 Blacklisting

If a public obligee, such as the federal government, believes the claim response of a particular surety is unsatisfactory, the surety is often "blacklisted." As an example, suppose that a surety has issued contract bonds with a prime contractor as principal, and a public owner as obligee. A dispute arises between the contractor and the public owner. The contractor abandons the project for reasons that the surety believes, or claims to believe, are legally sufficient. The public owner makes demand upon the surety to complete, and the surety declines, informing the owner that in its view its principal has properly terminated the contract and with it the surety's performance bond obligation. Litigation ensues and the public owner sends a letter to the surety informing the surety that the owner will no longer approve any bonds issued by that surety. The surety has been blacklisted.

There are defenses available to the surety which may be successful in eliminating the threat or at least delaying it. Public owners generally blacklist unsatisfactory sureties for about a three year period (46:1).

CHAPTER 4
THE DEFAULTED CONTRACTOR

4.1 Communicate and Plan

The majority of construction firms will probably be defaulted by their clients on a bonded project at some time in their life span, some more often than others. The suretys' prequalification requirements help minimize the situation, but surety bonds are issued at the start of contracts which routinely last a year or longer. A contractor's financial position can change greatly during that period. The particular financial troubles and the often accompanying involuntary bankruptcy proceedings are too varied and complex to discuss in this report. In addition, contractor terminations for default regularly result from what the project owner perceives to be a contract breach by the contractor. A construction firm faced with a default action should do everything it can to minimize its potential losses. To successfully weather a default and a surety takeover, the firm's leadership must understand their rights as indemnitors, the company's rights, their subcontractor's and supplier's rights, the rights of the surety, and the project owner's rights.

A contractor should advise its surety as problems progress, long before ever reaching the point of an actual termination for default. The contractor should confront its surety honestly, with a thought-out plan to correct the problems, and prevent them from occurring again. If the banks will not extend the contractor a line of credit, the surety may, if it is convinced the contractor is better "alive than dead." If financing is provided by the surety, the contractor and surety need to clearly agree with one another on who will be making the financial decisions on the project, as well as the many other decisions to be made. This must be communicated early on, to prevent misunderstandings later.

4.2 Minimize Losses

Once a contractor has been defaulted, regardless of how proper or improper the default is, it is in the contractor's best interest to stay involved with the project in some way. The surety will perform an investigation into the causes and events leading up to the termination to determine how it should proceed. The surety may employ a consultant unknown to the contractor for this. Again, the contractor should be honest and forthright with the surety. The contractor should share all correspondence, schedules, and other documentation with the surety. Generally the contractor will desire to execute the remainder of the project as a

contractor to the surety, rather than see the surety contract with another firm. Without delay, the contractor should provide the surety an organized plan of action to complete the project, and seriously entertain any suggestions by the surety to replace personnel or subcontractors. The contractor should remove project supervisory personnel who are confrontational or lacking in communication skills. (Often, this is all the project owner wanted in the first place.) If the surety does decide to stick with the original contractor, they must agree upon the control to be exercised by both parties. If there are any valid claims against the project owner, the contractor should prepare detailed documentation for the surety as soon as possible.

The contractor must also keep its subcontractors well informed, or at least at bay. In order to minimize added costs, it is important that they remain on the project. This is true when a new contractor is brought in to complete as well. The price to complete will be minimized by maintaining the same stable of subcontractors, provided any delay costs are controlled. It may be best if a major subcontractor is able to assume the roll as the prime contractor. Also, if the terminated contractor is aware of any omissions by the subcontractor, it should advise the surety, providing leverage for the surety's negotiations with the subcontractor. The contractor should prepare a

detailed list of work items which remain to be completed on the project and submit it to the surety to assist in preparing a new contract.

The surety will ask the contractor to review and approve a contract with another completing contractor. The contractor must examine the scope of work closely. There should be no work included which was not a part of the original contract, and there should be no work included which was already accomplished by the terminated contractor. A contractor cannot review this too closely, and may be advised to not approve it. However, if not approved, the surety may agree with the project owner to have the owner award the contract to complete. The owner will have less ability to minimize costs than the surety, so choosing to not approve the surety's contract to complete may be a mistake.

The terminated contractor may recommend to the surety which contractors to invite to bid, or negotiate with, on the completion contract. It should keep informed on the results of the bid. The bids should reflect that the contractors have an accurate understanding of the scope of work. The terminated contractor should stay advised of the progress of the project. Items which are a problem for the new contractor may give weight to the terminated contractor's claims against the project owner. The owner is likely to assess liquidated damages against the surety for

the total number of days delay past the original contract completion date. There are a number of defenses against this simplistic approach. They should be considered with the surety.

When projects go sour and financial difficulties multiply, the contractor should do its best to go back to the management methods and principles that made it successful in the first place. Most failures are caused by underbidding, an action that can be avoided.

CHAPTER 5
CONCLUSION

Surety bonding plays a very important role in the construction industry. Almost every public construction contract, and an increasing number of private contracts, require surety bonds to protect the project owner, subcontractors, and suppliers against any failure by the contractor to fulfill its obligations. The three types of bonds generally used are the bid bond, payment bond, and performance bond. The bonding process involves a thorough prequalification of contractors in order to determine their character, their capacity to meet the particular challenges of a given project, and their capital standing.

The construction business is very risky, which is probably why many contractors think of themselves as gamblers, and their sureties encourage them to only enter into projects and ventures in which they have previous successful experience. However, armed with skill, good judgement, resources, imagination, and a willingness to work, contracting can potentially be quite lucrative. Hopefully a "good contractor" will never be in a default situation, but it could become unavoidable at some point. Surety law involves a vast array of statutes, common law,

rules, and exceptions directly related to the construction profession. Contractors, subcontractors, and suppliers should develop a basic understanding of surety law, even if they do not intend to work on public contracts.

APPENDIX A
FINANCIAL STATEMENT FITNESS

The following is a list of suggestions from a manual entitled Boosting Your Bonding prepared by a surety bond producing agent, Keller, Zanger, Bissell & Company, of Rockville, Maryland:

Contract receivables - Reconcile the total receivables balance between completed contracts, uncompleted contracts, retainages and unbilled receivables. Completed contract receivables are given more weight by a surety than uncompleted contract receivables because the collection risk is less, However, a large balance of unbilled receivables on completed contracts may raise questions about a contractor's internal control over its billing process. Accounts receivable older than ninety days are usually discounted by the surety.

Under and Overbillings - The financial statements should contain a footnote explaining the under and overbillings at the balance sheet. The footnote should include the cost incurred on uncompleted contracts, estimated profit and amount billed. Sureties will discount underbillings out of proportion to total contract volume.

Contract backlog - Sureties want to know the total volume a contractor is already committed to complete. A schedule of uncompleted contracts is a good gauge of the contractor's operations.

Inventory - Inventory is typically discounted fifty percent by the surety. Bonding qualifications may improve if a company can expense material as job costs and record a greater percentage of completion on open contracts at the end of the year.

Work-in-process - Instead of using a work-in-process account, a contractor can treat the costs as inventory with an explanatory footnote in the financial statements. Another option is to show the work-in-process on the percentage of completion basis with a resulting under or overbilling account.

Costs and estimated earnings in excess of billings (underbillings) - This account will be examined very closely, especially if it appears out of line with receivables. Failure to bill jobs in progress on a timely basis can cost not only needed cash but also bonding capacity.

Notes receivable, stockholders and others - Generally discounted 100 percent by the surety.

Prepaid expenses - A surety will rarely consider these current assets.

Notes payable - Treated as current liabilities, if note matures in twelve months or less.

Notes payable, stockholder - Treated as equity if the note is subordinated to the surety; however, most stockholder notes are already subordinated to the bank.

Billings in excess of costs and estimated earnings (overbillings) - Indicates that strong billing practices are enforced. Billings in excess result from excess billings over recognized revenues under the percentage of completion method of accounting and is classified as a current liability.

Debt to equity ratio - Sureties usually require a debt to equity ratio less than 3 to 1. If the ratio is greater, the contractor may have to invest additional capital. If notes payable to stockholders exist, a surety may request that all or part of the liability be converted to capital.

Net quick ratio - The net quick ratio is a significant test of immediate solvency. The contractor's working capital is reduced by the following assets: prepaid expenses, inventory of materials and supplies not charged to jobs, accounts and loans receivable from officers, stockholders and related parties (which have not been paid by the date the statements are presented to the surety) and unsettled claims for tax refunds.

Schedule of gross profit - The schedule of gross profit indicates the contractor's estimating competence. the surety carefully reviews the gross profit rates of the completed contracts with those of uncompleted contracts.

> If the rates are approximately equal, the contractor is a very competent estimator.
>
> If the rates of the completed contracts are higher than those on uncompleted contracts, then the contractor is conservative.

If the rates of the completed contracts are lower than those of uncompleted contracts, this may indicate the contractor is having difficulty determining accurate costs to complete jobs in progress.

In addition, the surety will compare the contracts in the schedule of gross profit with the same contracts listed in the prior year's schedule of uncompleted contracts. The surety will apply the same comparisons as above, noting any decrease in estimated gross profit or a profit fade from the prior year. (12:7-9).

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